[2017] UKFTT 425 (TC)

TC05889

Appeal number: TC/2016/02207

Income tax – property income – discovery assessment – whether appellant discharged HMRC assessments – appeal partially allowed - failure to notify penalties – whether abatement appropriate – appeal partially allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Mr ERROL ALMOND **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE ABIGAIL MCGREGOR
CHARLES BAKER FCA

Sitting in public at Fox Court, London on 7 November 2016 and 24 February 2017

The Appellant represented himself

Mr Stephen Goulding, presenting officer of HM Revenue and Customs, for the Respondents

DECISION

The appeal

1. Mr Almond appealed against assessments by HMRC for income tax due in each tax year from 1997-98 to 2010-11; a capital gains tax assessment in tax year 2010-11; and penalties for failure to notify HMRC of a liability to tax in respect of each tax year from 1997-98 to 2008-09.

2. Following the initial hearing on 7 November 2016, and in particular the evidenced presented by Mr Almond at that hearing, HMRC withdrew its defence against the appeals in relation to each tax year from 1997-98 to 2001-2, and from 2007-08 to 2009-10; its capital gains tax assessment in tax year 2010-11 and the associated penalties.

3. Therefore this decision deals only with the appeal against the remaining assessments, being income tax assessments for each tax year from 2002-03 to 2006-07 and 2010-11 and penalty assessments for failure to notify in respect of each tax year from 2002-03 to 2006-07.

Evidence

4. Mr Almond submitted a large number of documents in evidence and gave oral evidence at the hearing. We found Mr Almond to be a credible and helpful witness, who was clearly trying to sort out his tax affairs following this enquiry. However, due the effluxion of time, there were inevitably some areas where memory did not provide the necessary detail.

5. HMRC also submitted a bundle of documents and a witness statement of Ms Kerry Neylan, who is a HMRC compliance officer and had taken over the enquiry into Mr Almond's tax affairs in December 2014.

Law

6. HMRC have the power to raise a discovery assessment under TMA 1970, s 29, which provides as follows (to the extent relevant):

> (1) If an officer of the Board or the Board discover, as regards any person (the taxpayer) and a year of assessment—
>
> (*a*) that any income which ought to have been assessed to income tax, or chargeable gains which ought to have been assessed to capital gains tax, have not been assessed, or
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> (*b*) that an assessment to tax is or has become insufficient, or
>
> (*c*) that any relief which has been given is or has become excessive,
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> the officer or, as the case may be, the Board may, subject to subsections (2) and (3) below, make an assessment in the amount, or the further amount, which

ought in his or their opinion to be charged in order to make good to the Crown the loss of tax.

(2) Where—

(a) the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, and

(b) the situation mentioned in subsection (1) above is attributable to an error or mistake in the return as to the basis on which his liability ought to have been computed,

the taxpayer shall not be assessed under that subsection in respect of the year of assessment there mentioned if the return was in fact made on the basis or in accordance with the practice generally prevailing at the time when it was made.

(3) Where the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, he shall not be assessed under subsection (1) above—

(a) in respect of the year of assessment mentioned in that subsection; and

(b) in the same capacity as that in which he made and delivered the return,

unless one of the two conditions mentioned below is fulfilled.

7. The time limits for making such an assessment are set out in TMA 1970, ss 34 and 36. The time limit where the case involves a loss or income tax or capital gains tax attributable to a failure by the person to comply with an obligation under section 7 of TMA 1970 is set at 20 years after the end of the year of assessment to which it relates by TMA 1970, s 36(1A)(b).

8. Property income is calculated in accordance with the principles set out in section 272 of the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005"), which incorporates a number of the core statutory provisions relating to the calculation of trading profits, including:

(1) ITTOIA 2005, s 33, which excludes deductions for expenditure of a capital nature, and

(2) ITTOIA 2005, s 34, which provides that expenditure of a revenue nature is only deductible if incurred wholly and exclusively for the purposes of the trade or business.

9. The prior iteration of the property income provisions, in sections 21A and 74 of the Income and Corporation Taxes Act 1988, contained almost identical provisions.

Facts

10. We find the following facts were either uncontroversial or were agreed during the course of the hearing between the parties. Further facts where there was dispute are set out in the discussion below.

11. Mr Almond acquired 79 Caister Drive ("Caister") in June 1997 and 5 Royal Court ("Royal Court") in 1998. Both purchases were financed by remortgaging Mr Almond's main residence, 64 Essex Road.

12. Caister was empty for the whole of tax years 2002-03 to 2008-09. It was then let out from 27 May 2009 to Mr Almond's nephew Darren. He paid no rent in 2009-10 and £7976 in 2010-11.

13. Royal Court was let out from 1 July 2002 until 17 June 2010 when it was sold through a compulsory purchase order. It was rented to Mr Almond's son and family throughout this period. Rent was paid via housing benefits received from Basildon Council.

14. Following the sale of Royal Court, Mr Almond purchased 121 Somercotes ("Somercotes") on 1 July 2010. This property was rented out to a third party tenant from 1 December 2010. She paid only £850 in rent and then went into arrears which were never paid.

15. Although Mr Almond received rent in the years 2007-08 to 2009-10, HMRC accept that the assessable total was less than his available personal allowance and so there was no tax liability (hence HMRC's withdrawal of their defence of those assessments). The rental receipts for the tax years that remain under appeal are summarised in the table below:

Tax year	2002-03	2003-04	2004-05	2005-06	2006-07	2010-11
Royal Court	2,648	5,590	6,310	6,500	6,500	1,500
Caister	0	0	0	0	0	7,976
Somercotes	0	0	0	0	0	850
Total rental income	2,648	5,590	6,310	6,500	6,500	10,326

16. Mr Almond did not notify HMRC of any chargeability to income tax and did not submit any tax returns for the tax years under appeal.

17. HMRC commenced a compliance check by sending a letter to Mr Almond on 19 March 2012.

18. Mr Almond responded to that letter by making a phone call on 26 March 2012.

19. This was followed by a series of correspondence between Mr Almond and HMRC including an information notice issued on 26 April 2013 requesting additional records or receipts to support Mr Almond's expense claims.

20. This enquiry culminated in the issue of notices of assessment in respect of all tax years 1997-98 to 2010-11 on 28 January 2015. These were accompanied by a penalty assessment, also issued on 28 January 2015, in respect of the tax years 1997-98 to 2008-09.

21. Mr Almond appealed to HMRC against these assessments. A meeting was held on 4 June 2015 and further correspondence between Mr Almond and HMRC ensued. On 11 January 2016, HMRC issued its view on the assessments, offering a statutory review, which Mr Almond accepted.

22. The outcome of the statutory review was sent to Mr Almond on 18 March 2016. A number of assessments were reduced or removed, but the review upheld:

(1) income tax assessments for the tax years 1997-98 to 2010-11;

(2) a capital gains assessment for 2010-11; and

(3) penalty assessments for failure to notify penalties the tax years 1997-98 to 2008-09 (reduced in accordance with the income tax assessments), which were abated as follows:

(a) for disclosure on challenge, 15% out of a maximum of 20%

(b) for co-operation with the check, 15% out of a maximum of 40%; and

(c) for seriousness, 20% out of a maximum of 40%.

23. Mr Almond appealed against these assessments on 15 April 2016.

Parties arguments

HMRC submissions

24. HMRC submit that the discovery assessment is validly made under TMA 1970, s 29 because:

(1) there was income that had not been assessed to tax;

(2) the conditions in subsections (2) and (3) of TMA 1970, s 29 do not apply because Mr Almond did not submit any tax returns in the relevant years; and

(3) the assessment involved a loss of income tax attributable to the failure by Mr Almond to comply with an obligation under TMA 1970, s 7, which includes the obligation to give notice to HMRC that he was chargeable to income tax.

25. HMRC submit that the penalty assessment is validly made under TMA 1970, s 7. Sub-section 8 allows HMRC to impose a penalty where a person has not provided a return for a year and there is a tax liability for the year that has not been paid on or before 31 January in the year after the end of the tax year. HMRC submit that these conditions are met in each of the tax years 2002-03 to 2006-07.

26. HMRC submit that the penalty abatement levels applied, pursuant to HMRC's discretion under TMA 1970, s 100, were correct given the circumstances of the case at the date of the issuance of the penalty, in particular because:

(1) Mr Almond's disclosure could not be classified as full disclosure because further information continued to be provided over a long period of time;

(2) Mr Almond's co-operation in the early stages was not ideal, in particular he was slow to come forward with information and at one stage a formal information notice was required; and

(3) the seriousness of the omissions was substantial, both with regard to the amount of money at stake and the length of time over which Mr Almond had failed to notify.

27. HMRC submit that insufficient evidence has been supplied to justify Mr Almond's claims for expenses to set off against his property income. Therefore HMRC has assessed based on an estimate of 20% of income to be set off against property income in each relevant year.

28. HMRC also submit that expenses in relation to Caister up until 2010-11 are not allowable in calculating the income of Mr Almond's property business because the property had not been rented out and was being used for private purposes.

Mr Almond's submissions

29. Mr Almond made no submissions with regard to the validity of the discovery assessment, save for confirming that he had not notified HMRC of his tax liability or submitted any tax returns for the relevant years because he didn't realise he had to do it.

30. With regard to the penalties, Mr Almond submits that the abatement of the penalties should be higher, in particular:

(1) on disclosure, he has given HMRC everything he could and had kept in touch with HMRC from the beginning of the enquiry;

(2) on co-operation, he has always co-operated with HMRC, albeit that there was a hiatus in communication when Mr Almond's daughter moved home (which is where he had received his correspondence) and Mr Almond forgot to tell HMRC; and

(3) on seriousness, while Mr Almond accepted that the failure had gone on for a long time, the amount at stake is not in fact that high.

31. The bulk of Mr Almond's submissions and evidence (once the figures on income were agreed between the parties) related to the expenditure incurred on the Royal Court and Caister properties. However Mr Almond conceded at the hearing that he accepted that no expenses could be claimed on Caister up until it was rented out. Mr Almond claimed the following expenses in respect of Royal Court:

32. £3,600 of mortgage interest each month (divided equally between Caister and Royal Court) for the tax years 2002-03 to 2006-07 (no mortgage interest was claimed in respect of 2010-11 because the mortgage had been paid off). No documentary evidence was provided to support the figure of £3,600. Mr Almond stated in evidence that, from memory, the mortgage payments started at £350/month and came down to £300/month over time.

33. Service charges for each year, supported in each case by dated invoices from Basildon District Council. For some years, Mr Almond had listed the provisional amounts paid. The final figures on the invoices were as follows:

(1) 2002-03: £824.70

(2) 2003-04: £766.87

(3) 2004-05: £1202.71

(4) 2005-06: £701.82

(5) 2006-07: £1153.86

34. Council tax for Royal Court:

(1) £118.55 for the period from 1 April 2002 to 23 June 2002, ie the period before it was let out to his son; and

(2) £30.92 for the period 31 May 2010 to 10 June 2010 when the property was unoccupied before demolition

35. Endowment payments of £300 for each tax year from 2002-03 to 2006-07. Mr Almond did not provide any documentary evidence of these payments.

36. General property expenses, including repair work, boiler servicing, gas and electrical certificates, insurance, wear and tear allowance. Mr Almond submitted in his oral evidence that some of these related to amounts that 'he must have paid' in order to carry on renting out the property, obtaining housing benefit from Basildon District Council, and some of them were expenses that he was sure he had incurred, for example on the replacement of a boiler, but had no documentary evidence of the expenditure.

Discussion

Discovery assessment

37. The burden of proof is on HMRC to show that the discovery assessment is valid. As there is no dispute that Mr Almond did not submit any tax returns in relation to the tax years 2002-03 to 2006-07 or 2010-11 (see paragraph 29 above), we agree with HMRC's submission that the only pre-condition for the validity of the discovery assessment is that it is made within the time limits in TMA 1970, ss 34 and 36.

38. We find that TMA 1970, s 36 applies to Mr Almond because the income tax lost is attributable to his failure to notify HMRC of his liability to tax under TMA 1970, s 7 and that therefore the time limit of 20 years applies. HMRC made the assessments

in 2015, which is within the 20 year time limit from the end of the earliest year of assessment, being 2002-03.

39. Therefore we find that the discovery assessment was validly made.

Rental expenses

40. Before discussing quantification, we will deal with some issues of principle on the expenses claimed or mentioned by Mr Almond. This is a broad-brush explanation of our thinking as applied to this particular case and is not intended as a refined analysis of the law.

41. As a general principle, expenses may only be deducted from rental income if they are revenue expenditure wholly and exclusively incurred for the purpose of the rental business, in accordance with ITTOIA 2005, s 272 as set out at paragraph [8]). In this case, almost all the rent came from connected persons (via the housing benefit received from Basildon Council) and Mr Almond accepted that overall the rent was below market rate. It follows that the expenditure was not wholly and exclusively for the purpose of the property rental business but partially to support his family. On the basis of the strict legal provisions, these expenses would therefore not be allowable at all. However, in these cases, HMRC have a well-established practice of allowing expenses that would otherwise qualify but capped at the amount of the rental income. Consequently, no losses are carried forward from year to year. This practice is set out in HMRC's Property Income Manual at section PIM2220. It seems to us that this is a fair and reasonable approach.

42. Subject to issues relating to quantification, interest on a mortgage taken out to acquire a rental property is in principle deductible. The premiums on a related endowment policy are not. This is because an endowment policy is a means of saving to repay the capital sum. Insurance for the structure and the landlord's contents of the property is allowable. So are service charges levied by the superior landlord, which in this case included insurance of the building. Servicing, maintenance and repairs of gas and electrical appliances are allowable. Broadly, expenditure to put the property in a fit state for letting is not allowed because it is considered to be capital in nature but repairing subsequent deterioration is allowable. Council tax is a liability of the occupier but is allowed if paid by the landlord out of the rental income.

(a) Mortgage interest

43. We were shown a solicitor's statement dated 26 June 1997 showing an advance from Barclays Bank of £43,980. The statement shows this advance being applied in the purchase of 79 Caister Drive for £24,500 plus costs. We accept Mr Almond's evidence that the balance was applied to purchase 5 Royal Court in approximately September 1998. We were also shown a statement from Barclays dated 12 February 2009 setting out the amount required to redeem the mortgage on each working day between 18 February 2009 and 20 March 2009. From that, we can see that the balance would be between £44,256 and £44,347. We can also infer that the interest charged was £3.01 per day which is approximately 2.48% pa. We saw no

documentary evidence about the mortgage account between the start in June 1997 and the proposed redemption in Spring 2009.

44. We accept that 79 Caister Drive and 5 Royal Court had approximately equal values on acquisition and it would therefore be appropriate to allocate half of the mortgage interest incurred against Royal Court. So we accept that £540 pa would be the approximate annual interest cost attributable to 5 Royal Court in early 2009 (being half the £3.01 per day based on the Barclays statement in 2009). It is common knowledge that interest rates were higher in earlier years but we have no direct evidence of the interest rate applicable to this mortgage in those earlier years and no evidence to support Mr Almond's contention that the mortgage interest was £3,600 per annum. Therefore we find that a figure of £540 per annum is a reasonable assessment of the mortgage interest attributable to Royal Court for each of the tax years 2002-03 to 2006-07 (pro-rated in the first year as a result of the partial rental).

(b) Service charges

45. The service charge figures submitted by Mr Almond are supported by appropriate invoices and we find them to be deductible in full against the rental income in each of the tax years 2002-03 to 2006-07 and 2010-11.

(c) Council tax

46. The only evidence presented by Mr Almond related to the periods during which Royal Court was not rented out. In addition, in relation to the tax year 2010-11, the invoice shown to the tribunal in fact shows that an exemption for unoccupied properties applied and therefore no council tax liability arose. Therefore we are not able to find that any deduction was due in respect of council tax against income on Royal Court.

(d) Other expenses

47. For the period concerned, landlords of ***fully*** furnished property had the option of claiming a 10% wear and tear allowance or the cost of replacing worn out contents. We accept that the property was furnished to a large extent, but we have no direct evidence that it was ***fully*** furnished and, since Mr Almond did not submit any tax returns, no claim was made for wear and tear allowance in respect of any of the relevant properties.

48. Mr Almond also submitted that substantial works were completed on at least two occasions at significant cost to him. However, since Mr Almond was unable to substantiate this submission with any evidence and, from the descriptions given it seems likely that for the first occasion at least, the expenditure was likely to have been capital expenditure to bring the property into a rentable state, we are unable to find that any amounts are deductible in relation to this expenditure.

Assessable income and tax payable up to 2006-07

49. Since the parties now agree on the amount of gross rental income, the remaining question relates to the allowable expenses. HMRC proposed to allow an arbitrary 20% deduction from the gross rental income to allow for expenses. Taking only the

services charges and interest and ignoring other expenses for which there is no documentation, the result for the years up to and including 2006/07 comes remarkably close to HMRC's arbitrary 20%. A table setting out the calculations is in the appendix to this decision and shows the difference between the HMRC assessments and the calculation based on the service charge and mortgage interest as we have found to be deductible above. The burden of proof is on the taxpayer to discharge HMRC's estimates, and, on balance, we find that Mr Almond's evidence has discharged that burden in relation to the service charge and mortgage interest and therefore replace HMRC's 20% estimate with these figures, which produces a slightly lower tax assessment for Mr Almond.

50. For the years up to 2005-06, Mr Almond was in employment and so his personal allowance would have been used against that income, therefore in the table in the appendix, no personal allowance is deducted in calculating the income tax due for those years.

51. Mr Almond retired from employment on 19 July 2006 so, in the ordinary course, the PAYE system would have left eight–twelfths of his personal allowance unused. At the second hearing, Mr Almond produced a letter from the payroll agency listing his pay and tax details for the tax years 2001-02 to 2006-07 inclusive. Those figures are consistent with him having been given five-twelfths of a personal allowance and starting rate band in 2006-07. We are aware that some educational establishments work on the basis that staff leaving at the end of the summer term are deemed to leave at the end of August, so that is possible.

52. Working on the basis that seven-twelfths of the personal allowance (£2,937) and starting rate band (£1,254) are available against the rental income, the tax payable for 2006-07 becomes £347.34.

Assessable income and tax payable for 2010-11

53. Mr Almond let three properties during the tax year. He was letting Royal Court to one relative until its compulsory sale on 17 June 2010. He let Caister to another relative from 27 May 2010. With the money from the sale of Royal Court, he bought 121 Somercotes. That property was in poor condition and after renovation he let it to a third party. However, she defaulted on most of the rent due and left the premises in a damaged condition, requiring extensive repair. We accept that Mr Almond would have made a loss on that third-party letting but do not have the evidence to quantify that loss.

54. As the mortgage had been paid off before this tax year, there were no deductions for mortgage interest. Mr Almond produced evidence of the service charge payable on Caister, but not in relation to Royal Court or Somercotes. Therefore we do not find that Mr Almond has discharged the burden of displacing HMRC's assessment. Therefore allowing the arbitrary 20% for expenses on the family lettings against the income of £10,326 gives a rental profit of £8260. Deducting the personal allowance of £6,475 gives taxable income of £1,785 and tax payable of £357.00.

Penalties

55. Mr Goulding confirmed that HMRC had not raised any penalty determinations for 2009-10 onwards and that the only penalty determination under appeal was raised under section 7(8) Taxes Management Act 1970 for the years 1997-98 through to 2008-09.

56. As noted earlier, the penalty applies where a taxpayer has failed to notify HMRC that he is chargeable to income tax. Mr Almond acknowledged that he had so failed and was liable to the penalty. The amount of the penalty is 100% of the tax unpaid by 31 January following each relevant tax year. That penalty is subject to mitigation in accordance with well-established principles. Section 100B(2)(b) of the Taxes Management Act 1970 gives this tribunal the power to amend the penalty determination to such amount as we consider appropriate.

57. HMRC has applied an overall abatement of 50% comprising:

- for disclosure on challenge, 15% out of a maximum of 20%
- for co-operation with the check, 15% out of a maximum of 40%
- for seriousness, 20% out of a maximum of 40%

58. Mr Almond argued that each of these abatements should be higher. He pointed out that the opening letter from HMRC was dated 19 March 2012 and he had telephoned to respond on 26 March 2012. He had answered the questions that were asked which were about his current rental property. He had not thought to talk about the historic position. On this basis, we conclude that his initial disclosure was good but not complete and a 15% abatement is appropriate.

59. We disagree with HMRC on the abatement for co-operation. Our impression of the correspondence is that Mr Almond was trying to resolve the issue and answer the questions that were asked. HMRC did use their formal powers to request information on one occasion. However, that was unnecessary since the only information requested was for additional receipts for expenditure. HMRC could simply have taken a view in the absence of receipts. On the other hand, there is no doubt that it would have helped considerably if Mr Almond had produced to HMRC a bundle of the quality he produced to us. Taking these factors together, we consider that 25% would be an appropriate abatement for co-operation.

60. We also disagree with HMRC on the abatement for seriousness. At the time of their conclusion, HMRC were of the view that Mr Almond had failed to declare substantial amounts over a long period. We now know that the amounts were smaller and over a shorter period. Furthermore, his conduct was a simple failure to notify chargeability. He had never attempted to disguise the income. Apart from one brief, failed attempt at commercial letting, his properties were occupied by relatives or their partners so he could, albeit mistakenly, not regard himself as a commercial landlord. For these reasons we consider a 30% abatement appropriate. That gives a total abatement of 70%, resulting in a penalty rate of 30%.

Decision

61. We allow in part the income tax appeals for the following years and reduce the tax payable to:

2002-03, £357.50

2003-04, £942.26

2004-05, £1,004.74

2005-06, £1,156.76

2006-07, £260.66

2010-11, £357.00

The total tax liability being £4,078.92

62. We allow in part the appeal against the penalty under section 7 Taxes Management Act 1970 and reduce the amount payable to £1,116.58.

63. We allow in full the appeals against the income tax assessments for all the other years and against the capital gains tax assessment, on which HMRC had withdrawn its defence of the assessments.

64. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

ABIGAIL MCGREGOR
TRIBUNAL JUDGE

RELEASE DATE: 16 MAY 2017

Appendix

Tax year	2002/03	2003/04	2004/05	2005/06	2006/07
Income	2,648	5,590	6,310	6,500	6,500
Service charge	618	767	1,203	702	1,154
Estimated mortgage interest	405	540	540	540	540
Total expenses	1,023	1,307	1,743	1,242	1,694
Profit	1,625	4,283	4,567	5,258	4,806
Tax @22% (or 10% for starting rate band in 2006/07)	357.5	942.26	1,005	1,157	260.66
HMRC assessment	466	983	1,111	1,144	1,144
Difference	108.50	40.74	46	(13)	883.34

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